

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Natasha Chevalier  
Attorney (Dallas, Group 2)  
(Small Business/Self Employed)

from: Jason A. Spitzer, Senior Technician Reviewer, Branch 6  
Office of Associate Chief Counsel (Procedure & Administration)

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Office of Associate Chief Counsel (Corporate)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Creditor =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1            =

aa                =

bb                =

mm               =

nn                =

oo                =

pp                =

qq                =

rr                =

ss                =

**Issue**

Whether a court order when an Agreed Motion to Dismiss with Prejudice was issued and signed on Date 1, resulted in the discharge of Taxpayer's debts with Creditor as of Date 1.

**Conclusion**

The issued and signed court order does not determine the discharge date of Taxpayer's debt with Creditor. The terms of the Settlement Agreement determine the timing of the actual discharge of taxpayer's debt.

**Facts**

The taxpayer is attempting to claim additional basis in its shares of S corporation stock by relying on Gitlitz v. Commissioner, 531 U.S. 206 (2001). The holding in Gitlitz provides that cancellation of debt income excluded from an S corporation's income may be added to a shareholder's stock basis. Gitlitz was subsequently appealed when Congress amended IRC §108(d)(7)(A). This amendment became effective on October 11, 2001. Therefore, the holding in Gitlitz still applies to any discharge of indebtedness that occurred prior to October 11, 2001. Thus, the date on which the debt at issue was cancelled becomes critical in instant case.

On Date 2, taxpayer, an S corporation, entered into a Term Loan Agreement with an unrelated third party lender (“Creditor”) and executed several Secured Promissory Notes in favor of various Creditor entities by which taxpayer borrowed \$mm from Creditor at a stated interest rate of aa% per year. The Notes further provided that, in addition to the aa% coupon rate of interest, the loan to taxpayer would also consist of the conveyance of a “royalty adjustment” sufficient to yield Creditor a bb% internal rate of return. Additionally, any overdue interest or principal amounts bore interest at bb%.

During Year 1, taxpayer’s partners began experiencing financial difficulties that resulted in taxpayer defaulting on the required payments to Creditor. Taxpayer sued the partners who failed to make payments on corporate obligations and received a \$nn jury verdict and judgment on Date 3. Since the judgment, which was later backed by a cash bond in favor of the defendants, was a substantial asset of taxpayer, Creditor decided to await the outcome of the defendants’ appeals before pursuing taxpayer’s collateral. On Date 4, taxpayer executed in favor of Creditor additional security agreements under the Notes.

In , the \$nn judgment was reduced on appeal to \$oo. Of that amount, Creditor ultimately received \$pp since the judgment was divided among several parties. The appellate court suggested that the reduction in the judgment was due in part to malpractice of taxpayer’s attorneys. Thereafter taxpayer filed a lawsuit against its attorneys. Creditor filed a Plea in Intervention in that lawsuit, claiming that taxpayer owed Creditor principal of \$qq under the Notes, plus interest, royalties and other amounts, and asserted a right to recover those amounts from any liability adjudged to be due taxpayer from its former attorneys.

In its Plea in Intervention Creditor claims that it should be permitted to intervene in the malpractice action because it had “prior perfected first security interest in all property, proceeds and other collateral owned by taxpayer. This security interest extends to any judgment or settlement proceeds taxpayer may collect in this case.” Creditor argued that it was entitled to intervene in the action because of its interest in the subject matter of the litigation and the disposition of the action in Creditor’s absence may have impeded its ability to protect its security interest. Creditor specifically stated in the Plea that it was seeking to intervene in the action in order to protect its interest in any property owned by taxpayer. The prayer for relief contained in the Plea stated that Creditor sought to recover any and all amounts that taxpayer was entitled to recover from defendants. Pleas in Intervention were also filed by two other parties. Taxpayer filed Motions to Strike Interventions regarding all three parties that sought to intervene.

The court’s Order on Motions to Strike Interventions divided the action into the “Main Phase,” which referred to the portion of the action that included claims asserted by the taxpayer against the attorneys, and the “Intervention Phase,” which referred to the portion of the action which included the claims, counterclaims and cross-claims asserted by and among any of the intervenors and taxpayers, any third-party claims which may have been asserted by any of such parties pertaining to the issues involved

in the Intervention Phase, and the defenses asserted to such claims, counterclaims, cross-claims, third party claims, as such claims, counterclaims, cross-claims, third party claims. The Order on Motions to Strike specifically provided that the Intervention Phase was limited to claims, counterclaims, cross-claims and third party claims relating to interests in the cause of action asserted by taxpayer against the attorneys in the Main Phase and/or any proceeds thereof which are paid through judgment or settlement. The attorneys were not parties to the Intervention Phase, which was to be handled in a trial that was separate from the Main Phase.

All of the parties involved in the Main Phase and/or the Intervention Phase eventually negotiated a settlement amongst themselves which was memorialized in a Confidential Settlement and Release Agreement (the "Settlement Agreement"). The Settlement Agreement states that effective as of the Creditor Effective Date as to the taxpayers only and as to the Collateral Claims, and effective as of the Creditor Payment Date as to all other taxpayer released parties other than with respect to the Collateral Claims, Creditor unconditionally, fully and completely released and forever discharged the taxpayers from any and all obligations, claims, demands, actions, causes of action, suits, debts, liens, deficiencies, accounts, notes, covenants, contracts, agreements, promises, liabilities, etc. whatsoever, known or unknown, accrued or unaccrued, asserted or unasserted, contingent or otherwise, in law or equity arising prior to the Creditor Effective Date or Creditor Payment Date, respectively. The "Creditor Effective Date" was defined as the date which is five months after the Creditor Payment Date. "Collateral Claims" is defined as any obligation, claim, demand, action, cause of action, lien, security interest, contract or agreement which relate to or comprise any real or personal property collateral or security pledged or encumbered by any taxpayer released party to secure any debt or obligations to any of Creditor including without limitation, the Notes.

The language in the Settlement Agreement specifically states that the release was intended to be general and inclusive and therefore the claims to be released shall include any claims in any way related to or in any manner arising out of the previous Notes. In furtherance of the forgoing release, effective as of the Creditor Effective Date, the Notes shall be deemed cancelled by Creditor.

In furtherance of the Settlement Agreement, on Date 1 (a date before October 11, 2001) the parties filed an Agreed Motion to Dismiss with Prejudice wherein it stated that plaintiffs, defendant and intervenors "no longer wish to prosecute claims among them" and that they requested that the action be dismissed with prejudice "as to all claims, cross-claims or counterclaims brought or that could have been brought herein."

Accordingly, the Order Granting Agreed Motion to Dismiss with Prejudice (the "Order") states that the:

cause of action in the present case is hereby DISMISSED WITH  
PREJUDICE towards refiling the same as to all claims, cross-claims or

counterclaims brought or that could have been brought herein, including the claims in the intervention phase, with each party bearing its own attorneys' fees, costs and expenses.

At the time of the Order, taxpayer's total indebtedness to Creditor was approximately \$rr. As a result of the Settlement Agreement, Creditor received approximately \$ss.

### **Analysis**

The Order dismissed the cause of action and barred Creditor from pursuing any claims that were brought in the malpractice action or those which could have been brought within the action. The consideration for doing so was that each party entered into the Settlement Agreement, which served as a binding contract between them. The Settlement Agreement served as a general release, completely releasing taxpayer from any and all debts that were outstanding with regard to its obligations to Creditor as of the Creditor Effective Date, a date subsequent to the date of the Order. When all of the parties signed the Settlement Agreement, it created contract rights that could be judicially enforced amongst the parties. Thus, in the event a payment was not received by Creditor pursuant to the Settlement Agreement, Creditor could seek subsequent judicial assistance in enforcing the Settlement Agreement. If Creditor had no further rights with respect to the debt as of the filing of the Order, then there would be no incentive for a payment to be made to Creditor subsequent to the entry of the Order. As Creditor clearly had further rights effective subsequent to the Order, there was no discharge of Taxpayer's debts to Creditor as of the date of the Order.

Please call Meghan Mahaney at 202-622-6869 or Mark Weiss at 202-622-7750 if you have any further questions.

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Mark J. Weiss

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Jason A. Spitzer